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March 26, 2004

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW, Room TWB-204
Washington, DC 20554

Re: Notice of Oral Ex Parte Communication, In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, WC Docket No. 03-173

Dear Ms. Dortch:

Yesterday, Prof. Robert Willig, Rich Clarke, David Levy and the undersigned, representing AT&T, met with Steve Morris, Marvin Sacks, Alvaro Gonzalez, Jay Atkinson, Jeremy Marcus, Monica Desai and Dick Kwiatkowski to discuss AT&T's filed comments in the above-referenced proceeding and to make the attached presentations.

Consistent with Commission rules, I am filing one electronic copy of this notice and request that you place it in the record of the above-referenced proceedings.

Sincerely,

A handwritten signature in black ink, appearing to be "Joan Marsh", written over a horizontal line.

Joan Marsh

cc: Jeremy Marcus

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Cost Concepts for Competitive Prices

- Long run costs – like TELRIC – are forward looking from today, cost minimizing, and unconstrained by the firm's past investment decisions.
- Short run (and medium run) costs are still cost-minimizing looking forward from today, but – unlike long run costs – reflect a planning period in which investments in long-lived assets inherited from the past remain sunk.

- Short run costs include all forward-looking new expenditures needed during the planning period.
- They also might include capital costs on the inherited sunk assets themselves.
- Economists have identified three alternative approaches to the valuation of the sunk assets with corresponding costs.

One Approach: No Value for Sunk Assets with No Opportunity Costs

- Since the investment is sunk, there is no opportunity cost of using it. (That is, if you decide not to use the assets, no costs of their financing are thereby saved or avoided; likewise, if you decide to use them, there are no additional such costs that result.)
- Short run costs, so defined, are necessarily equal to or less than long run costs.
- This follows because in the short run scenario, one way to produce the same outputs would be to ignore the sunk assets and buy all inputs fresh. Hence, if the owner of the sunk assets elects to continue using them (as incumbent carriers typically do), doing so must be as cheap as, or cheaper than, starting fresh.

The Reproduction Cost Approach

- The reproduction cost approach values sunk assets at the cost of reproducing the physical assets that happen to be in place today.
- If the enterprise unconstrained by any sunk assets would efficiently choose exactly the same assets that had been chosen historically, then $SRC = LRC$.
- If intervening technological progress and other changes in economic circumstances would change those choices, then the appraised value of those sunk assets is less than their reproduction cost. So a measure of short run cost that includes their reproduction cost is systematically biased upward.
- That is why this approach violates economic logic.

Economic Valuation of Sunk Assets

- The economic approach would assign costs to the inherited sunk assets according to their appraised value.
- The appraised value of the assets is the savings their use would permit an enterprise in the business, as compared to not using the assets and starting fresh.
- If the sunk assets were not used at all, the enterprise would incur long run costs.
- Since the appraised value makes the enterprise indifferent between using the sunk assets or not, this standard leaves the enterprise with $SRC = LRC$.
- So TELRIC yields calculated costs that are the short run or “real costs” based on economic valuation of sunk assets!!!!

This Profound Fact Has Been Known Since at Least 1970!!!

- "If the economic value were correctly stated on the books the addition of gross return on that net book value to the variable costs of operating the old plant would produce a cost of service exactly equal to that of a new plant."
- Alfred Kahn, Economics of Regulation, vol. I, page 121 (1970).

Pricing Based on such Costs is Compensatory

- Current prices are based on current efficient costs with efficient long-run choices of assets.
- The expected decline from original value to current value of sunk assets is included in economic depreciation, and thus in prices.
- The chances that actual declines in value will deviate from the expected are risk factors in the cost of capital.
- This is all so in competitive pricing and in efficient pricing based on economic costs.

TELRIC Dominates

- TELRIC is a superior regulatory approach
- Minimizes misincentives to over spend and cross-subsidize
- Historic cost and “real” cost methods produce sharp misincentives that are costly for consumers and anticompetitive.

Fundamental Principles of Efficient Economic Pricing

WC Docket No. 03-173

March 25, 2004

Overall principles

- Efficiency must be measured on a forward-looking basis; competitive markets do not mark suppliers' performance on a "curve"
- Economic prices must reflect the relevant incremental costs for the forward-looking planning period assumed
 - Additives or subtractives to these costs are subsidies
 - Adjusting embedded costs to "current market" does not convert such costs into incremental costs
- Economic prices must reflect the efficient cost of the service or element being provided
 - If capabilities are subtracted, so must be their cost
 - The best solution is to permit use of the element's full capability

Overall principles

- Interconnection/element prices must be consistent with regulatory rate-setting processes that are used to set these prices
 - Methodology must be comprehensive, transparent and permit all parties' knowledge to be contributed to the process
 - Methodology must provide proper incentives for truthful disclosure and principled competition
 - Methodology must rely on available data and provide reliable cost estimates
- TELRIC conservatively meets all of the above requirements

Market basics and time horizons

- Markets are unforgiving of inefficiency. They have no “memory” and don’t care about:
 - What a supplier may have spent or done in the ancient past
 - What a supplier may have spent or done recently
- Markets care only about what a supplier needs to spend or do to serve the customer in the future
- This future may be:
 - Immediate (short run)
 - Intermediate (medium run)
 - Indefinite (long run)

Time horizons and efficiency

- Shorter planning periods generally reduce the quantities of total cost that are incremental
 - All sunk costs are ignored
 - Only the portion of future costs that will actually be incremented over the period may be included
- Efficiency may be measured with respect to different time horizons:
 - Series of historically-framed decisions concerning choice of network configuration and cost incurrence
 - Current/static view of efficient choices going forward (i.e., current best input prices, technology and demand)
 - Current/dynamic view of efficient opportunities going forward (i.e., expected future best input prices, technology and demand)

Measuring efficiency

- Historic network configurations cannot usefully provide the basis for forward-looking estimates of efficient costs
 - Embedded network configurations reflect the cost structure that was forward-looking only when these engineering and installation decisions were made
 - Current technical/demand/competitive opportunities are likely much different
 - Costs determined by applying “current” input prices to embedded assets and network configurations shed no light on the original efficiency of the embedded configuration or the efficiency of its continued use now or in the future
- To replicate the performance of a competitive market, embedded assets must be revalued to reflect the efficiencies of a new network. The result will be TELRIC.

Williams example

- The Williams Companies placed long-haul fiber cables in some of its decommissioned gas pipelines
- What cost concept informed Williams' pricing decisions in the competitive long-haul fiber market?
 - Short-run cost was incremental cost of fiber cable placement
 - Long-run efficient cost was burying fiber cables in the ground along telecom-optimized routes (Sprint/TELRIC)
 - "Adjusted embedded network cost" (as appears to be proposed by the ILECs) would be the incremental cost of fiber placement plus the "current" cost of reproducing Williams' pipeline structure in its embedded route configuration

Limitations on pertinent costs

- Historic network configurations inform efficient current and future decisions only because they may limit the universe of costs that are incremental
 - In some cases, historical configuration choices may cause short-run incremental costs to exceed LRIC (e.g., continuing to operate a fission nuclear power plant that generates radioactive waste requiring disposal at immense additional incremental cost)
 - In other cases (e.g., local telecom), these choices may cause short-run incremental costs to be below LRIC because telecom plant is of large capacity, is long-lasting and its use benign
- The least cost-limiting definition of efficiency is long-run, forward-looking/dynamic
 - Presumes all future evolutions in technology and cost
 - In modern telecom, this means efficiency and cost levels well below calculations of currently achievable efficiency and cost

Efficiency and TELRIC

- TELRIC reflects only forward-looking efficiency that is currently achievable
 - Current wire center locations and boundaries
 - Current technology, input prices and demand (and typically, these parameter values are lagged several years)
 - These restrictions avoid “speculation” about future developments
- Resulting efficiency level is a significant compromise between historical and dynamic forward-looking views
- At bottom, efficiency must be measured on a forward-looking basis because competitive markets do not mark suppliers’ performance on a “curve”

Efficient pricing

- Economic prices must reflect incremental costs
 - Prices inform customers' purchasing decisions
 - Customers (both wholesale and retail) are deciding whether they should purchase a particular telecom service/element, or whether they should purchase something else (and purchasing nothing/saving is always an option)
 - Incremental costs inform RBOCs' investment and production decisions
 - Suppliers are deciding whether to produce and sell an additional unit, or whether they should stand pat or produce something else
- The market is inefficient unless the marginal choices of customers match the marginal choices of suppliers
- This occurs only when *Price = Incremental Cost*

Efficient pricing

Source: The Economics of Regulation, 2nd ed., by J. L. Krashinsky, 1994, p. 100.

- Setting a price below incremental cost will cause:
 - “too much” of the good to be demanded and produced; and
 - “too little” compensation to be provided to the producer to ensure continued supply
- Setting a price above incremental cost will cause:
 - “too little” of the good to be demanded and produced
 - “too little” investment by suppliers; and
 - “too much” compensation to be provided to the producer
- Price “additives” or “subtractives” relative to incremental costs are political/social subsidies that provide windfalls either to:
 - Favored customers; or to
 - Current stockholders and management of favored suppliers

Conforming prices to capabilities

- Economic prices must reflect the efficient cost of the service/element being provided
- If the element is defined to incorporate all of its capabilities, then the full efficient cost of its production is the appropriate price
- If the element is defined to exclude some of its capabilities, then its full efficient cost is the minimum cost of supplying the functionality that is being provided
- Although the best solution is to permit CLECs use of the full capabilities of elements, TRO limitations require the development of a “separations-like” mechanism

Consistency with regulatory processes

- Pricing methodologies must be consistent with regulatory rate-setting processes
- Methodology must be implementable in a manner that is:
 - Comprehensive
 - Transparent
 - Permits all parties' knowledge to be contributed to the process
- This requires pricing to be based on knowledge that:
 - Exists; and is
 - Reliable, accurate and detailed
- Methodology must provide proper incentives for truthful disclosure and principled competition
 - Same information must inform element pricing as informs ILEC competitive behavior

Fidelity of TELRIC

- TELRIC focuses on current opportunities for efficiency over the long run
 - All costs are incremental
 - All capabilities are included
- Identical principles generally appear to inform ILEC investment decisions
 - At minimum, are evolving their embedded networks to current view of forward-looking (fiber DLC, SONET rings, etc.)
 - Are actually implementing even greater efficiency (increased use of remote switches, conversion of circuit transport to IP, etc.)
- In competitive markets, the same principles also inform ILEC pricing decisions (e.g., wireless)

Fidelity of TELRIC

■ TELRIC includes:

- Sufficient capacity adequate to meet existing and reasonably expected demand for all network services
- Cost of capital that reflects fully the risks faced by an ILEC in its supply of UNEs to a competitive telecommunications market
- Depreciation allowances that reflect as accurately as possible the expected pattern of decline in the economic value of ILEC plant
- Full reimbursement of the ILECs' expected cost of operating, maintaining and repairing their wholesale network
- Additives to cover a generous allocation of joint and common costs
- Cost calculations with detail adequate to reflect the differing cost characteristics of different zones

Conclusions

- The only efficiency relevant to competitive pricing is forward-looking efficiency
- Economic prices must reflect the relevant incremental costs for the forward-looking planning period assumed
- Economic prices must reflect the efficient cost of the service/element being provided
- TELRIC is implementable and less speculative than all reasonably-proposed alternatives – but remains a compromise relative to full dynamic long run forward-looking costs